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Giving Credit where it's Due: Promoting Financial Inclusion through Quality Credit Unions

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ABSTRACT Early in 2005, HM Treasury established a Financial Inclusion Task Fund to support initiatives to tackle financial exclusion. It envisages that a substantial proportion of this funding will be allocated to third sector lenders such as credit unions operating in low-income areas. During the 1980s and early 1990s, public investment in credit unions was misdirected. This resulted in community credit unions remaining small and having only marginal impact within financially excluded communities. Since 1999, significant transformation has taken place in the credit union sector, which has resulted in credit unions developing as market-oriented and commercial social enterprises with a capacity to tackle financial exclusion both imaginatively and effectively at a borough wide, city-wide and sometimes county wide level.

Credit Unions and a Sense of Social Mission

Excluded from mainstream financial services, many people in low-income communities have no choice but to pay the high interest rates of home credit companies and other alternative lenders (Palmer & Conaty, 2002; Jones, 2001), often placing considerable strain on household budgets (Collard & Kempson, 2005). Palmer & Conaty (2002) argue that such high cost lending is 'stripping the wealth and assets of some of the country's poorest neighbourhoods'. For many community volunteers, inspired by a strong sense of social mission, credit unions offered a solution to the financial needs of disadvantaged communities and a vehicle for

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regenerating the local economy (Thomas & Balloch, 1994; Donnelly, 2004). Eighty-three per cent of community credit unions were formed as community development projects or to provide services for disadvantaged people (Jones, 1999).

By the end of the 1980s, political support for credit unions had grown significantly and they had become regarded, particularly by local government, as important anti-poverty initiatives. With local authority grants and resources, the credit union movement expanded rapidly throughout Britain. In 1986, seven years after the Credit Unions Act 1979, there were only 94 British credit unions. By 2000, this had grown to almost 700, the majority of which were in low-income neighbourhoods (Donnelly, 2004). A national survey, conducted in 1998, revealed that 87% of community credit unions were established with local authority support (Jones, 1999).

However, the rise in the number of credit unions was not matched by a rise in the number of credit union members benefiting from the services of credit unions. By 1998, with few exceptions, the average membership of a community credit union in England and Wales was around 200 members and only four were recognised as self-sufficient and economically viable according to criteria utilised by the Birmingham Credit Union Development Agency at the time (Jones, 1999). This was clearly problematic as it resulted in credit unions being unable to establish the capacity necessary to develop the range of financial services required by people on low incomes. The potential of credit unions, recognised by UK central and local government (HMT, 1999a and b; LGA, 2001), to combat financial exclusion, and to build wealth in communities, was not being realised. In 1999, local authorities acknowledged that the outcome of public investment had not matched up to expectations (LGA, 1999).

The lack of membership growth in community credit unions was not replicated, in the same way, in all credit unions. Much higher rates of growth were found in credit unions formed for employees who shared a common bond based on their place of work or field of employment. Such credit unions often benefited from a degree of in-kind sponsorship from the employer such as free office space and telephone or time off for employees to volunteer in the credit union. By the end of the 1990s, credit unions established with an employer's sponsorship made up 15% of all credit unions, but accounted for 50% of all members and 70% of all assets in the British credit union movement. Donnelly & Haggett (1997) refer also to a small group of community credit unions in West Central Scotland that also sustained higher rates of growth. These credit unions were established, often with influence from Ireland, as mutual self-help organisations without an overriding focus on serving the poor.

By the mid-1990s, two factors had already been identified to explain the lack of growth of British credit unions; restrictive legislation and weak national trade association support (NCC, 1994; Co-operative Commission, 2001; Donnelly, 2004). However, these two factors alone could not fully explain the low growth rates among community credit unions, for all credit

unions were subject to these same factors, including the employee credit unions and those in West Central Scotland that had grown more successfully. The 1999 research study, *Towards Sustainable Credit Union Development* (Jones, 1999) identified yet another factor. It revealed that lack of growth was due primarily to the internal organisational and financial structure of credit unions themselves. Most community credit unions had been established according to a particular social development model, which was not conducive to expansion.

The Traditional Social Development Model

The social development model was based on an understanding of credit unions as small, local volunteer-run community organisations established primarily to provide low cost loans to poor people who had little access to mainstream financial services. High priority was given to community involvement, member participation and the social and personal education of the volunteers who managed the organisation. Much less priority was given to business objectives and to the development of quality services necessary for long term sustainable development. The overall impact of this development model was to result in many financially weak credit unions, with little organisational capacity and with an ongoing dependence on external grants and subsidies. Member services were often poor, with many credit unions operating out of unsuitable premises for just a few hours a week (Jones, 1999). Traditional model credit unions were just not built for growth. In fact, in many cases, growth was regarded as a threat to the community-oriented culture of credit unions and to their manageability by volunteers. Moreover, social development model credit unions, established for the poor, were often perceived by the poor as poor people's banks, a perception which itself restricted growth within low-income communities (NCC, 1994; Jones, 1999).

The Emergence of New Model Credit Unions

The traditional model of credit union development is now recognised as having been strong on social ideals but as having insufficiently emphasised financial and economic realities. This was confirmed in the 1999 research study (Jones, 1999), which argued that community credit unions had to adopt a more professional and business approach if they were to develop their capacity to serve low income communities. In general, this was accepted by large sections of the credit union movement and the Association of British Credit Unions (ABCUL), the sector's largest trade association, began to promote a more business focused approach to credit union development, a move that received both the support of Government and of municipal authorities (HM Treasury, 1999a, 1999b; LGA, 2001). Local authorities recognised they had often regarded credit unions as

social welfare initiatives but now needed to see them instead as 'community business enterprises operating to appropriate commercial standards' (LGA, 1999).

However, international case studies have demonstrated that the transformation of social model credit unions into stable and effective financial institutions entails not merely the adoption of basic business practices, as envisaged in the 1999 report, but rather a radical financial, organisational and operational restructuring (Arbuckle, 1994; Richardson, 2000a, 2000b; Branch & Cifuentes, 2001). This restructuring has come to be known as new model credit union development (Arbuckle & Adams, 2000; Richardson, 2000b; Jones, 2004b, 2005) and is understood as a major correction in the management of credit unions so that they are better able to serve the poor and financially excluded. Essentially, as Richardson describes, new model development is based on seven 'doctrines of success' (Richardson, 2000a). These are serving the financial needs of the population at large, maximising savings by offering attractive interest rates, portfolio diversification, operating efficiency, financial discipline, self-governance and assimilation. By assimilation, he means the capacity of bringing the financially excluded 'into the mainstream economy by providing them with access to comparable financial products and services' (Richardson, 2000a). This new model approach is markedly distinct from the operation of traditional model credit unions that focus solely on serving the poor, are borrower oriented and that offer only a limited range of financial products within the alternative lending market.

Influenced by the international movement, many British credit unions began to rethink their future in terms of a 'new model' of development, which, for many, was a completely new way of thinking about credit union organisation and operations. It has entailed adopting modernised procedures in order to attract savings deposits and, through effective lending, to generate sufficient income to cover expenses, build capital reserves and pay attractive dividends. Unlike the traditional model, the new model stresses a clear commercial approach to enterprise.

The commercialisation of credit unions has met with resistance from certain sections of the British credit union movement (Brown *et al.*, 2003). There was a fear that, in their search for economic success, credit unions would lose their distinctiveness as socially driven organisations. Yet, new model methodology arose directly out of a desire to effect poverty alleviation, through sustainable credit union development, in Latin America and the third world (Branch & Cifuentes, 2001). The paradox, that many British credit unions have had to face, is that, if credit unions are to achieve the social goal of combating financial exclusion, they have first to attain economic viability and commercial success (Richardson & Lennon, 2001). Richardson & Lennon (2001) have argued convincingly that the restructuring of credit unions, using a commercially oriented methodology, has revolutionised credit unions throughout the world and, by extension, that it could have a similar impact in Britain.

The Development of Quality Credit Unions

Transforming traditional social model credit unions into modern, market oriented community-owned not-for-profit financial institutions, with a capacity to combat financial exclusion effectively, is not an easy process. The Association of British Credit Unions (ABCUL) has developed a number of projects based on new model methodology. One such project, *Creating Wealth in the West Midlands through Sustainable Credit Unions* (Jones, 2005), assisted credit unions to restructure in ways that prioritised financial discipline, economic strength, professionalism and quality in financial services. Over a three-year period, the project introduced West Midlands credit unions to new business and market-oriented practices, modernised lending procedures and a new financial structure based on a financial monitoring system invented by the World Council of Credit Unions (Richardson, 2001). It also encouraged directors and staff to rethink the governance and management of their organisations. Traditionally, in many credit unions, operated as small collectives, the boundaries between governance and management were blurred, as volunteers were often immersed in operations. However, worldwide, the distinct role of the board of directors in leading change has been recognised as critical to credit union success (Arbuckle, 1994; Branch & Cifuentes, 2001).

Importantly, the West Midlands project challenged credit unions to re-think their position in the financial market and to develop a more customer-oriented approach to business. It endeavoured to assist credit unions to attract a wider range of people into membership by the quality of the products and services on offer rather than by convincing them to share a passion for a pre-existing credit union ideology and accept compromises in product suitability, accessibility and quality of service. For credit unions taking part in the project offering the kind of products and services that people want, and operating commercially, ensured financial strength and independence from external subsidy.

A key example of credit union reform was in the area of credit assessment. Traditional social model credit unions offered simple savings and loan accounts with identical conditions to all sections of the market. An obligatory 12-week savings period preceded any loan application, the amount of the loan was then limited to twice or three times the amount saved. Savings could not be withdrawn if they were exceeded by a loan balance, a practice that actively deterred borrowers from saving more than they needed to access a loan the size they wanted. These restrictions, which were neither legal nor regulatory requirements, were custom and practice in many credit unions and arose out of a focus on providing low cost credit as an alternative to high-cost doorstep lenders. The challenge was to recognise these restrictions were unattractive to many existing and potential members and, consequently, unprofitable. It had a particularly negative impact in the low-income market as people in need of an instant loan, or unable to save, could not be helped as they could not afford to save as a condition of qualifying for a loan. An adoption of new model

methodology removed the link between saving and lending and enabled credit unions to develop lending policies that were flexible, efficient and responsive to member needs. Instead of restricting a borrower's access to their savings, new model credit unions minimise risk by introducing effective credit administration and lending based on a capacity to repay. Rather than obliging people to save, maximising savings is achieved by establishing a market rate annual dividend payment and permitting access to savings on demand.

New model methodology furnished West Midlands's credit unions with a road-map for their transformation into more effective financial institutions. Credit unions following this map became known, in the British movement, as 'quality credit unions', a term that seems less prescriptive than 'new model'. As defined by ABCUL (2005), a quality credit union is one that:

- 'has a strong capable board with the skills, sense of urgency and capacity to drive the credit union towards sustainability;
- researches what its members want and seeks to provide services to meet those needs;
- is a flexible lender—does not require people to save before they borrow;
- is a responsible lender—assesses loan requests on the capacity to repay;
- emphasises savings mobilisation recognising that sustainable financial intermediaries are built on member savings not external capital;
- gives their members somewhere to deposit their wages or benefit and gives them easy access to their cash and a means of simply carrying out basic transactions'.

Credit unions in the West Midlands that began to put into place the organisational and operational elements of the quality credit union model began to achieve some notable success. In the period March 2002 to December 2004, savings in five beacon credit unions, defined as those credit unions participating in the project in a more intense manner, rose by 47% and outstanding loans increased by 49%. This compared with growth rates of 26% in savings and 22% in loans in the other 50 plus West Midlands Credit Unions. These rates represent annual growth rates, from March 2002 to October 2004, of 18% in both savings and loans in beacon credit unions compared with 10% in savings and 8% in loans in non-beacon credit unions. Overall, the growth rate of savings and loans in beacon credit unions were nearly twice those for non-beacon credit unions.

The Impact of the New Regulatory Regime

In July 2002, credit unions became regulated as deposit takers by the Financial Services Authority (FSA). The introduction of this new regulatory regime marked a step forward in the strengthening of credit unions as quality financial institutions. For the first time, a culture of compliance was introduced and all credit unions had to meet defined threshold conditions

and prudential standards for operation. They were expected to provide timely financial returns to the FSA, maintain adequate levels of capital and meet defined standards in liquidity management and provision for loan losses. In return credit union deposits were insured by the Financial Services Compensation Scheme; this provided credit union members with the same level of depositor protection as customers of banks and building societies.

With the introduction of new regulation came changes in credit union legislation, arguably until then the most restrictive in the world (Co-operative Commission, 2001). No longer were credit unions limited to serving a maximum number of members and relaxations were also introduced to the upper limits of savings and loans balances. Different regulatory requirements were introduced for credit unions, enabling a Version 2 credit union to operate under more stringent capital, liquidity and supervision requirements in return for which they would have greater flexibility to make larger loans over longer periods. They could also offer variable dividend rates on savings accounts, and pay dividends more often than once a year. Arguably, these relaxations in the law meant that credit unions now had more opportunity to compete and to respond to the financial market.

Tackling Financially Exclusion

A lack of access to mainstream financial services, also known as financial exclusion, is characterised by six key elements: lack of a bank account, no savings, no assets, no access to money advice, no insurance or access to affordable credit (HM Treasury, 1999b, 2004). To varying degrees, financial exclusion affects 7.9 million people in the UK (Datamonitor, 2004). Around 2.8 million adults are, for example, without access to any kind of bank account and 3 million are regular users of the alternative credit market (HM Treasury, 2004). Given the struggle many people experience in making ends meet on a very low income, it is not surprising that local Citizens Advice Bureaux are now dealing with well over a million new debt enquiries per annum (Edwards, 2003).

An effective response to financial exclusion must address each of the six elements noted above, in a coordinated and holistic manner. A response that tackles the indebtedness to high interest lenders that often accompanies financial exclusion must also include one-to-one personal support, financial education and assistance with budgeting and money management (Jones, 2003; Jones & Barnes, 2005).

Considerable research has been undertaken into the financial needs of low-income groups (Collard & Kempson, 2005; Kempson, 1996, 2002; Kempson & Whyley, 1999; Jones, 2001). This research highlights the importance of developing quality financial products that contain product features attractive to people experiencing financial exclusion.

Modernised quality credit unions have become increasingly recognised as being able to deliver the range and the quality of financial products and services appropriate to tackling financial exclusion. Collard & Kempson (2005), Rossiter & Cooper (2005), the National Consumer Council (2005), and McKillop & Wilson (2003) all point out how the needs of the financially excluded are best served within strengthened and professional new model credit unions. Separating saving from lending has enabled quality credit unions to serve people in need of a loan but without the capacity to save in advance. Around the country, professionally organised quality credit unions are beginning to offer financially excluded groups access to flexible savings accounts, instant and accessible loans, bill payment accounts, affordable home and contents insurance and access to money advice and debt counselling services.

Southwark Credit Union in London has 5169 members, of which 306 already have a newly introduced Benefit Direct Account. This enables them to have their welfare benefits paid directly into a credit union account, which they can withdraw in cash at any one of the credit union's three branches. Importantly, the Benefit Direct Account, compared with, for example, a Post Office Card Account, has enabled members to retain as much as 9% of their benefit as savings in the credit union. The accumulation of savings is a recognised element in the move out of financial exclusion and towards financial independence and control (Sherraden, 1991; Regan & Paxton, 2001; Kempson *et al.*, 2005). With the security provided by the regular receipt of income from benefit, Southwark Credit Union has also been able to grant instant and accessible loans to low income members, who normally would have no other option but to borrow from high cost alternative lenders. It also provides access to a money advice service and offers affordable general insurance products. Southwark Credit Union therefore provides a holistic financial service for low-income consumers, which responds to nearly all elements of financial exclusion as identified by HM Treasury.

The Financial Inclusion Fund

In early 2005, consequent to the publishing of the report, *Promoting Financial Inclusion* (HM Treasury, 2004), the Government established the Financial Inclusion Task Force with a view to monitoring progress on its policy objectives aimed at tackling financial exclusion. This Task Force, bringing together people from the private and public sectors, the banks, the community finance and money advice sectors, has, within its remit, the oversight of how credit unions, and other third-sector lenders, could be supported to maximise their impact within low-income communities. The Task Force is backed up by a Financial Inclusion Fund, which amounts to £120 million over three years and which can be used to support initiatives to tackle financial exclusion in the areas of money advice, basic banking and affordable credit. In October 2005, it was announced that £36 million of

the fund would be a growth fund for credit unions and community development financial institutions, operating from April 2006 for a two-year period.

The response of the credit union movement to this new Government initiative was that 'credit unions need change, not just cash' (ABCUL, 2005). The lessons arising from public investment in credit unions throughout the 1980s and 1990s have been learnt and the priority for ABCUL, as for most credit unions, is that the reforms of recent years are built upon and extended. £36 million over two years can only make a difference if credit unions are prepared to commit themselves to a continued process of change. Public investment has to be tied to credit unions becoming more professional and market-oriented organisations, to their meeting defined operating standards and to their developing the capacity to make real difference in low income communities. Only then can Government be assured it is receiving value for money on its investment.

ABCUL, together with the other trade associations, has identified priorities for growth fund expenditure. Clearly the fund must be spent on credit unions operating in areas of high financial exclusion or serving financially excluded groups. Some of these credit unions, which have already adopted the principles of reform, will only require support with project development and the capitalisation needed to secure funds for on-lending. However, both ABCUL and others are agreed that, in order to maximise the impact of the fund, it will be necessary to work intensely with those credit unions that are willing and able to change on programmes of reform as exemplified in the West Midlands and elsewhere (Barclays, 2003). If the mistakes of the past are to be avoided, financial subsidy has to be regarded as a long-term investment and granted with specified conditions to meet agreed financial and operational targets. These conditions must also recognise that if credit unions are to serve low-income groups effectively, they must do so within the context of offering a quality financial service to the population at large. If the dynamics of the Financial Inclusion Fund result in credit unions being, once again, regarded as 'poor persons' banks', there will be losses all around.

British quality credit unions are already offering flexible savings and borrowing facilities to members but are increasingly recognising the importance of developing transaction account facilities. The Benefit Direct accounts, as offered at Southwark Credit Union, are an important first step towards the provision of transaction banking facilities, regarded as fundamental to serving low income consumers as the Government's commitment to basic bank accounts illustrates. However, credit union transaction accounts are currently limited in their operation—offering neither ATM access nor facilities for direct debts or standing orders.

The development of modern electronic transaction services is a key strategic goal within ABCUL's approach to developing services for credit union members, particularly those on low incomes. It is already working with a banking partner to provide credit unions with the equivalent of basic current accounts. About a dozen large credit unions that have been

working in partnership with ABCUL on the development of this service will roll out credit union current accounts by the end of 2006. With the support of the Financial Inclusion Fund, it is anticipated that a further 70 credit unions, operating in low income areas, will also have the capacity to offer credit union current accounts to their members. This major development will enable credit unions to make an increased contribution to tackling financial exclusion.

Can Quality Credit Unions Really Make a Difference?

Certainly, with the advent of quality credit unions, the British credit union movement has begun to develop the organisational and operational capacity to make a real difference within financially excluded and low income communities. Not only in Southwark, but in Newham, Portsmouth, Leeds, Rochdale, Edinburgh and many other cities around the country, modernised credit unions are leading the way in providing services to low income groups. Leeds Credit Union, for example, is probably one of the few financial institutions to offer savings accounts to sellers of the *Big Issue*.

Overall, the signs of change and of the strengthening of the credit union movement are positive. Yet, significant challenges still remain if credit unions are to fully realise their potential. There are an increasing number of credit unions that have absorbed the messages of quality methodology and are moving towards long-term sustainability while providing a significant service for those who are excluded. There are many others that have the potential and the desire for change but need assistance to transform themselves into quality credit unions. However, there are others with little capacity for growth or appetite for change. The danger is that these remaining traditional model credit unions will seek further public and private subsidies to fund a panoply of new schemes, which lead not to economic stability but to ever more dependence on grants and donor funds.

Recent research has consistently argued that credit unions, given the requisite organisational capacity, are best placed within the financial services industry, to serve those on low incomes (Conaty & Bendle, 2002; Whyley & Brooker, 2004; Regan & Paxton, 2003). There certainly is no evidence that mainstream lenders, including the banks, have any desire to serve low-income groups. Left to its own devices, the commercial market will leave the financially excluded with even less choice and much higher costs (Collard & Kempson, 2005).

New model methodology, and the concept of a quality credit union, offers British credit unions the opportunity to generate the capacity to offer low income and financially excluded groups the accessible and affordable services and products they need, want and deserve. The Financial Inclusion Fund will be able to support credit unions to consolidate progress and to develop new products and services, primarily electronic banking facilities. It will do this so long as credit unions are committed to adopting

commercial and market-oriented approaches that endeavour to reduce dependence on external subsidies over the two-year period of the funding.

Long term independent sustainability must be the driving force if credit unions are to serve low-income communities successfully into the future. They must look beyond external subsidies and to generate income from the business of lending. It is for this reason that there is a pressing need for the UK Government to change the maximum interest rate ceiling for credit unions (HM Treasury, 2005a) and to extend the Community Investment Tax Relief scheme to investments in credit unions (HM Treasury, 2005b). Both actions would strengthen credit union capability to generate income though lending activities, the first by generating increased income to cover costs of administration and of bad debt reserves and the second by encouraging external investors to deposit funds in credit unions for on-lending.

At the end of December 2004, there were just under half a million adult members of credit unions in England, Scotland and Wales.[1] These credit unions had assets of over £350 million and a loan book of over £285 million mostly consisting of short-term unsecured personal loans. Research undertaken by Hayton *et al*. (2005) suggests that 58% of credit union loans are for less than £1000, a key indicator of the use of credit unions by lower income groups. Given their transformation into quality credit unions, there is every indication that credit unions will be able to serve the low income market, and tackle financial exclusion, much more effectively than in the past.

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[1] FSA aggregate figures in December 2004 recorded 487,898 adult credit union members in Britain.

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